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SUBJECT: The "One-Two" Punch to Kenya's Economy

REF: (a) Nairobi 2328, (b) Nairobi 2040, (c) Nairobi 2166

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Summary

¶1. (SBU) Still recovering from the blow of post-election violence, the Kenyan economy is now being hit by the global financial crisis. This "one-two" punch spells trouble for Kenya's economic prospects at least over the short-term. Indicators of less than optimal growth include declining remittances (the country's number one foreign exchange earner), a falling shilling that will maintain inflationary pressure and partially offset gains from oil price drops, and a steadily declining stock exchange that has reached a three year low. At the same time, it is likely that tourism (already hard hit by the violence) and key Kenyan exports such as coffee and cut flowers will face reduced demand. All signs point to serious headwinds to economic expansion, something the country can ill afford in the midst of its efforts to remedy the root causes of the ethnically-charged post election violence. End summary.

Africa, Including Kenya, Not Immune from Global Crisis

¶2. (SBU) At an October 23 IMF briefing on its outlook for sub-Saharan Africa, IMF economists stepped back from earlier predictions that developing economies would be immune from the global economic crisis. It is now clear, according to the IMF, that such economies will experience lower demand for exports, declining or retreating foreign investment, higher inflation, likely declines in foreign assistance, weakening commodity prices, lower remittances and a fall off in tourism. Admittedly behind the curve on the entire crisis, IMF experts said they had been "surprised time and again at the complexity of this crisis."

¶3. (SBU) Kenya is subject to all these pressures and finds itself in a more difficult situation because it is still trying to recover from the disastrous economic results produced by the post-election violence earlier this year. Those events halved Kenya's projected 2008 GDP growth from 8 to 4 percent. (Note: The first quarter alone showed a negative 1.3 percent GDP retrenchment due to the violence.) Now, just when second quarter GDP results showed signs of a modest pick up (3.2 percent GDP growth), the economy faces the global financial/economic turmoil. Signs and projections that the Kenyan economy will face significant headwinds include:

-- Kenya's number one foreign exchange earner, remittances, is down about 20 percent from August 2007 to August 2008 (latest figures

available). Faced with economic slowdowns in the U.S. and Europe, the Kenyan diaspora will be less able to offer support to family members in Kenya. Remittances, per ref B, have been assisting Kenyan in recovering from the economic shock of January.

-- The Nairobi Stock Exchange (NSE), which has on average, 20 percent foreign participation on any given day, has dropped or been unchanged every day for almost the last two months, even temporarily halting trading on one day (ref A). From June 9 to October 24, it witnessed a 41.5 percent nosedive in capitalization, going from 1.3 trillion shillings ($16.3 billion) to 759.7 billion shillings ($9.5 billion). The NSE's benchmark 20 share index has reached a 3 year low, having lost 38 percent in the past four months. A part of its decline has been attributed to the departure of foreign portfolio investment from the market. Trading has slowed to a daily turnover of around 200 million shillings compared to 1 billion shillings in early summer 2008.

-- The Kenyan shilling has lost 27 percent of its value against the dollar since January 1, 2008; it's now at a four year low. The conventional wisdom is that the shilling is in decline mainly due to falling remittances, capital flight from the NSE, and weak tourist demand. As a result of the falling shilling, we don't expect inflationary pressures to ease because imports will remain dear (Kenya is a net importer). While falling oil prices should help ease transport and power prices (fuel generators produce 40 percent of Kenya's electricity), the falling shilling offsets some of these potential gains. Inflation, which was 9 percent in 2007, has

climbed to a monthly average of between 25-30 percent in 2008. Even with the upcoming recalculation of inflation, it is still in the 14-15 percent range (ref C). The Central Bank of Kenya (CBK) is down to a little more than three months of forex reserves (to cover imports), leaving it little margin to defend the shilling if demand for dollars remains relatively strong.

-- The demand for key Kenyan exports including long-haul tourism for safaris, cut flowers, and coffee are likely to decline in the months to come as export market demand drops. The Managing Director (MD) of the Serena Group of hotels in Kenya recently told diplomats and business leaders that 2008 will be the "worst year in history" for tourism, citing a major loss of corporate travel -- a component of the tourism sector that has held strong through previous crises in Kenya. Serena's MD said occupancy rates for Serena hotels across Kenya have dropped 20-40 percent from last year. He also noted a sharp decline of 60 percent in the number of available charter air seats to the coastal region - traditionally popular with European tourists. To make matters worse, occupancy rates are about 30 percent lower on the flights that are going and the tickets are heavily discounted.

-- GOK access to credit, particularly its proposed Eurobod issue, will become prohibitively expensive, making it more difficult to finance desperately need infrastructure upgrades. October 29 reports indicate that the Kenyan Ministry of Finance is indefinitely postponing the bond issue due to global financial circumstances.

-- Warnings about declining foreign direct investment certainly ring true given the intense competition for a smaller pool of available resources. Kenya is already seen by some U.S. businesses as less attractive than many of its competitors due to corruption, insecurity, poor infrastructure and high energy costs.

-- The IMF is concerned that official assistance flows will remain flat or decrease as a result of the global economic crisis. Charitable giving, which supports NGOs and foundations, will likely fall off, possibly resulting in a decline of such assistance to Kenya.

The Good News

¶4. (SBU) After facing negative growth in the first quarter due to the election violence, Kenya experienced a respectable second quarter growth rate of 3.2 percent. The third quarter may also show signs of recovery against a backdrop of continuing sound macroeconomic policies and pre-violence economic momentum. As recently as September, the IMF and others expressed optimism about

Kenya's return to strong growth in 2009. The positive leadership and cooperative relationship between President Kibaki and Prime Minister Odinga has brought calm, a critical foundation to political and economic reform/progress.

Comment

¶5. (SBU) Kenya's prospects for quickly returning to pre-violence growth rates of 7 percent are significantly diminished by the global economic slowdown and accompanying declines in remittances, export revenue, capital, and assistance; higher import costs exacerbate the problem. With economic frustration, particularly among youth, a key catalyst of the post-election violence, a stagnating economy is the last thing an already fragile Kenya needs. A message the Mission will be delivering is that now - more than ever - Kenya needs to redouble its efforts at political and economic reform. In particular, by quickly implementing constitutional reform the GOK would arguably put in place the most vital component of sustained economic growth: political stability. End comment.

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